

§ 1.904-4 Separate application of section 904 with respect to certain categories of income.

(a) *In general.* A taxpayer is required to compute a separate foreign tax credit limitation for income received or accrued in a taxable year that is described in section 904(d)(1)(A) (passive category income), 904(d)(1)(B) (general category income), or § 1.904-4(m) (additional separate categories).

(b) *Passive category income*—(1) *In general.* The term *passive category income* means passive income and specified passive category income.

(2) *Passive income*—(i) *In general.* The term *passive income* means any—

(A) Income received or accrued by any person that is of a kind that would be foreign personal holding company income (as defined in section 954(c)) if the taxpayer were a controlled foreign corporation, including any amount of gain on the sale or exchange of stock in excess of the amount treated as a dividend under section 1248; or

(B) Amount includible in gross income under section 1293.

(ii) *Exceptions.* Passive income does not include any export financing interest (as defined in section 904(d)(2)(G) and paragraph (h) of this section), any high-taxed income (as defined in section 904(d)(2)(F) and paragraph (c) of this section), or any active rents and royalties (as defined in paragraph (b)(2)(iii) of this section). In addition, passive income does not include any income that would otherwise be passive but is characterized as income in another separate category under the look-through rules of section 904(d)(3), (d)(4), and (d)(6)(C) and the regulations under those provisions. In determining whether any income is of a kind that would be foreign personal holding company income, the rules of section 864(d)(5)(A)(i) and (6) (treating related person factoring income of a controlled foreign corporation as foreign personal holding company income that is not eligible for the export financing income exception to the separate limitation for passive income) shall apply only in the case of income of a controlled foreign corporation (as defined in section 957). Thus, income earned directly by a United States person that is related person factoring income may be eligi-

ble for the exception for export financing interest.

(iii) *Active rents or royalties*—(A) *In general.* For rents and royalties paid or accrued after September 20, 2004, passive income does not include any rents or royalties that are derived in the active conduct of a trade or business, regardless of whether such rents or royalties are received from a related or an unrelated person. Except as provided in paragraph (b)(2)(iii)(B) of this section, the principles of section 954(c)(2)(A) and the regulations under that section shall apply in determining whether rents or royalties are derived in the active conduct of a trade or business. For this purpose, the term taxpayer shall be substituted for the term controlled foreign corporation if the recipient of the rents or royalties is not a controlled foreign corporation.

(B) *Active conduct of trade or business.* Rents and royalties are considered derived in the active conduct of a trade or business by a United States person or by a controlled foreign corporation (or other entity to which the look-through rules apply) for purposes of section 904 (but not for purposes of section 954) if the requirements of section 954(c)(2)(A) are satisfied by one or more corporations that are members of an affiliated group of corporations (within the meaning of section 1504(a), determined without regard to section 1504(b)(3)) of which the recipient is a member. For purposes of this paragraph (b)(2)(iii)(B), an affiliated group includes only domestic corporations and foreign corporations that are controlled foreign corporations in which domestic members of the affiliated group own, directly or indirectly, at least 80 percent of the total voting power and value of the stock. For purposes of this paragraph (b)(2)(iii)(B), indirect ownership shall be determined under section 318 and the regulations under that section.

(iv) *Examples.* The following examples illustrate the application of paragraph (b)(2) of this section.

Example 1. P is a domestic corporation with a branch in foreign country X. P does not have any financial services income. For 2008, P has a net foreign currency gain that would not constitute foreign personal holding company income if P were a controlled foreign

corporation because the gain is directly related to the business needs of P. The currency gain is, therefore, general category income to P because it is not income of a kind that would be foreign personal holding company income.

Example 2. Controlled foreign corporation S is a wholly-owned subsidiary of P, a domestic corporation. S is regularly engaged in the restaurant franchise business. P licenses trademarks, tradenames, certain know-how, related services, and certain restaurant designs for which S pays P an arm's length royalty. P is regularly engaged in the development and licensing of such property. The royalties received by P for the use of its property are allocable under the look-through rules of § 1.904-5 to the royalties S receives from the franchisees. Some of the franchisees are unrelated to S and P. Other franchisees are related to S or P and use the licensed property outside of S's country of incorporation. S does not satisfy, but P does satisfy, the active trade or business requirements of section 954(c)(2)(A) and the regulations under that section. The royalty income earned by S with regard to both its related and unrelated franchisees is foreign personal holding company income because S does not satisfy the active trade or business requirements of section 954(c)(2)(A) and, in addition, the royalty income from the related franchisees does not qualify for the same country exception of section 954(c)(3). However, all of the royalty income earned by S is general category income to S under § 1.904-4(b)(2)(iii) because P, a member of S's affiliated group (as defined therein), satisfies the active trade or business test (which is applied without regard to whether the royalties are paid by a related person). S's royalty income that is taxable to P under subpart F and the royalties paid to P are general category income to P under the look-through rules of § 1.904-5(c)(1)(i) and (c)(3), respectively.

(3) *Specified passive category income means—*

(i) Dividends from a DISC or former DISC (as defined in section 992(a)) to the extent such dividends are treated as income from sources without the United States;

(ii) Taxable income attributable to foreign trade income (within the meaning of section 923(b)); or

(iii) Distributions from a FSC (or a former FSC) out of earnings and profits attributable to foreign trade income (within the meaning of section 923(b)) or interest or carrying charges (as defined in section 927(d)(1)) derived from a transaction which results in foreign

trade income (as defined in section 923(b)).

(c) *High-taxed income—*(1) *In general.* Income received or accrued by a United States person that would otherwise be passive income shall not be treated as passive income if the income is determined to be high-taxed income. Income shall be considered to be high-taxed income if, after allocating expenses, losses and other deductions of the United States person to that income under paragraph (c)(2)(ii) of this section, the sum of the foreign income taxes paid or accrued by the United States person with respect to such income and the foreign taxes deemed paid or accrued by the United States person with respect to such income under section 902 or section 960 exceeds the highest rate of tax specified in section 1 or 11, whichever applies (and with reference to section 15 if applicable), multiplied by the amount of such income (including the amount treated as a dividend under section 78). If, after application of this paragraph (c), income that would otherwise be passive income is determined to be high-taxed income, such income shall be treated as general category income, and any taxes imposed on that income shall be considered related to general category income under § 1.904-6. If, after application of this paragraph (c), passive income is zero or less than zero, any taxes imposed on the passive income shall be considered related to general category income. For additional rules regarding losses related to passive income, see paragraph (c)(2) of this section. Income and taxes shall be translated at the appropriate rates, as determined under sections 986, 987 and 989 and the regulations under those sections, before application of this paragraph (c). For purposes of allocating taxes to groups of income, United States source passive income is treated as any other passive income. In making the determination whether income is high-taxed, however, only foreign source income, as determined under United States tax principles, is relevant. See paragraph (c)(8) *Examples* 10 through 13 of this section for examples illustrating the application of this paragraph (c)(1) and paragraph (c)(2) of this section. This paragraph (c)(1) is

applicable for taxable years beginning after March 12, 1999.

(2) *Grouping of items of income in order to determine whether passive income is high-taxed income*

(i) *Grouping rules—Initial allocation and apportionment of deductions and taxes.* For purposes of determining whether passive income is high-taxed, expenses, losses and other deductions shall be allocated and apportioned initially to each of the groups of passive income (described in paragraphs (c)(3), (4), and (5) of this section) under the rules of §§ 1.861-8 through 1.861-14T and 1.865-1 through 1.865-2. Taxpayers that allocate and apportion interest expense on an asset basis may nevertheless apportion passive interest expense among the groups of passive income on a gross income basis. Foreign taxes are allocated to groups under the rules of § 1.904-6(a)(1)(iii). If a loss on a disposition of property gives rise to foreign tax (i.e., the transaction giving rise to the loss is treated under foreign law as having given rise to a gain), the foreign tax shall be allocated to the group of passive income to which gain on the sale would have been assigned under paragraph (c)(3) or (4) of this section. A determination of whether passive income is high-taxed shall be made only after application of paragraph (c)(2)(ii) of this section (if applicable).

(ii) *Reallocation of loss groups.* If, after allocation and apportionment of expenses, losses and other deductions under paragraph (c)(2)(i) of this section, the sum of the allocable deductions exceeds the gross income in one or more groups, the excess deductions shall proportionately reduce income in the other groups (but not below zero).

(3) *Amounts received or accrued by United States persons.* Except as otherwise provided in paragraph (c)(5) of this section, all passive income received by a United States person shall be subject to the rules of this paragraph (c)(3). However, subpart F inclusions that are passive income, dividends from a controlled foreign corporation or noncontrolled section 902 corporation that are passive income, and income that is earned by a United States person through a foreign QBU that is passive income shall be subject to the rules of this paragraph only to the extent pro-

vided in paragraph (c)(4) of this section. For purposes of this section, a foreign QBU is a qualified business unit (as defined in section 989(a)), other than a controlled foreign corporation or noncontrolled section 902 corporation, that has its principal place of business outside the United States. These rules shall apply whether the income is received from a controlled foreign corporation of which the United States person is a United States shareholder, from a noncontrolled section 902 corporation of which the United States person is a domestic corporation meeting the stock ownership requirements of section 902(a), or from any other person. For purposes of determining whether passive income is high-taxed income, the following rules apply:

(i) All passive income received during the taxable year that is subject to a withholding tax of fifteen percent or greater shall be treated as one item of income.

(ii) All passive income received during the taxable year that is subject to a withholding tax of less than fifteen percent (but greater than zero) shall be treated as one item of income.

(iii) All passive income received during the taxable year that is subject to no withholding tax or other foreign tax shall be treated as one item of income.

(iv) All passive income received during the taxable year that is subject to no withholding tax but is subject to a foreign tax other than a withholding tax shall be treated as one item of income.

(4) *Dividends and inclusions from controlled foreign corporations, dividends from noncontrolled section 902 corporations, and income of foreign QBUs.* Except as provided in paragraph (c)(5) of this section, all dividends and all amounts included in gross income of a United States shareholder under section 951(a)(1) with respect to the foreign corporation that (after application of the look-through rules of section 904(d)(3) and § 1.904-5) are attributable to passive income received or accrued by a controlled foreign corporation, all dividends from a noncontrolled section 902 corporation that are received or accrued by a domestic corporate shareholder meeting the stock

ownership requirements of section 902(a) that (after application of the look-through rules of section 904(d)(4) and § 1.904-5) are treated as passive income, and all amounts of passive income received or accrued by a United States person through a foreign QBU shall be subject to the rules of this paragraph (c)(4). This paragraph (c)(4) shall be applied separately to dividends and inclusions with respect to each controlled foreign corporation of which the taxpayer is a United States shareholder and to dividends with respect to each noncontrolled section 902 corporation of which the taxpayer is a domestic corporate shareholder meeting the stock ownership requirements of section 902(a). This paragraph (c)(4) also shall be applied separately to income attributable to each foreign QBU of a controlled foreign corporation, noncontrolled section 902 corporation, or any other look-through entity as defined in § 1.904-5(i), except that if the entity subject to the look-through rules is a United States person, then this paragraph (c)(4) shall be applied separately only to each foreign QBU of that United States person.

(i) *Income from sources within the QBU's country of operation.* Passive income from sources within the QBU's country of operation shall be treated as one item of income.

(ii) *Income from sources without the QBU's country of operation.* Passive income from sources without the QBU's country of operation shall be grouped on the basis of the tax imposed on that income as provided in § 1.904-4T(c)(3)(i) through (iv).

(iii) *Determination of the source of income.* For purposes of this paragraph (c)(4), income will be determined to be from sources within or without the QBU's country of operation under the laws of the foreign country of the payor of the income.

(5) *Special rules—(i) Certain rents and royalties.* All items of rent or royalty income to which an item of rent or royalty expense is directly allocable shall be treated as a single item of income and shall not be grouped with other amounts.

(ii) *Treatment of partnership income.* A partner's distributive share of income from a foreign or United States part-

nership that is not subject to the look-through rules and that is treated as passive income under § 1.904-5(h)(2)(i) (generally providing that a less than 10 percent partner's distributive share of partnership income is passive income) shall be treated as a single item of income and shall not be grouped with other amounts. A distributive share of income from a foreign partnership that is treated as passive income under the look-through rules shall be grouped according to the rules in paragraph (c)(4) of this section. A distributive share of income from a United States partnership that is treated as passive income under the look-through rules shall be grouped according to the rules in paragraph (c)(3) of this section, except that the portion, if any, of the distributive share of income attributable to income earned by a United States partnership through a foreign QBU shall be grouped under the rules of paragraph (c)(4) of this section.

(iii) *Currency gain or loss—(A) Section 986(c).* Any currency gain or loss with respect to a distribution received by a United States shareholder (other than a foreign QBU of that shareholder) of previously taxed earnings and profits that is recognized under section 986(c) and that is treated as an item of passive income shall be subject to the rules provided in paragraph (c)(3)(iii) of this section. If that item, however, is received or accrued by a foreign QBU of the United States shareholder, it shall be treated as an item of passive income from sources within the QBU's country of operation for purposes of paragraph (c)(4)(i) of this section. This paragraph (c)(5)(iii)(A) shall be applied separately for each foreign QBU of a United States shareholder.

(B) *Section 987(3).* Any currency gain or loss with respect to remittances or transfers of property between QBUs of a United States shareholder that is recognized under section 987(3)(B) and that is treated as an item of passive income shall be subject to the rules provided in paragraph (c)(3)(iii) of this section. If that item, however, is received or accrued by a foreign QBU of the United States shareholder, it shall be treated as an item of passive income from sources within the QBU's country of operation for purposes of paragraph

(c)(4)(i) of this section. This paragraph (c)(5)(iii)(B) shall be applied separately for each foreign QBU of a United States shareholder.

(C) *Example.* The following example illustrates the provisions of this paragraph (c)(5)(iii).

Example. P, a domestic corporation, owns all of the stock of S, a controlled foreign corporation that uses x as its functional currency. In 1993, S earns 100x of passive foreign personal holding company income. When included in P's income under subpart F, the exchange rate is 1x equals \$1. Therefore, P's subpart F inclusion is \$100. At the end of 1993, S has previously taxed earnings and profits of 100x and P's basis in those earnings is \$100. In 1994, S has no earnings and distributes 100x to P. The value of the earnings when distributed is \$150. Assume that under section 986(c), P must recognize \$50 of passive income attributable to the appreciation of the previously taxed income. Country X does not recognize any gain or loss on the distribution. Therefore, the section 986(c) gain is not subject to any foreign withholding tax or other foreign tax. Thus, under paragraph (c)(3)(iii) of this section, the section 986(c) gain shall be grouped with other items of P's income that are subject to no withholding tax or other foreign tax.

(iv) *Coordination with section 954(b)(4).* For rules relating to passive income of a controlled foreign corporation that is exempt from subpart F treatment because the income is subject to high foreign tax, see section 904(d)(3)(E), § 1.904-4(c)(7)(iii), and § 1.904-5(d)(2).

(6) *Application of this paragraph to additional taxes paid or deemed paid in the year of receipt of previously taxed income—(i) Determination made in year of inclusion.* The determination of whether an amount included in gross income under section 951(a) is high-taxed income shall be made in the taxable year the income is included in the gross income of the United States shareholder under section 951(a) (hereinafter the “taxable year of inclusion”). Any increase in foreign taxes paid or accrued, or deemed paid or accrued, when the taxpayer receives an amount that is excluded from gross income under section 959(a) and that is attributable to a controlled foreign corporation's earnings and profits relating to the amount previously included in gross income will not be considered in determining whether the amount included in in-

come in the taxable year of inclusion is high-taxed income.

(ii) *Exception.* Paragraph (c)(6)(i) of this section shall not apply to an increase in tax in a case in which the taxpayer is required to adjust its foreign taxes in the year of inclusion under section 905(c).

(iii) *Allocation of foreign taxes imposed on distributions of previously taxed income.* If an item of income is considered high-taxed income in the year of inclusion and paragraph (c)(6)(i) of this section applies, then any increase in foreign income taxes imposed with respect to that item shall be considered to be related to general category income. If an item of income is not considered to be high-taxed income in the taxable year of inclusion and paragraph (c)(6)(i) of this section applies, the following rules shall apply. The taxpayer shall treat an increase in taxes paid or accrued, or deemed paid or accrued, on any distribution of the earnings and profits attributable to the amount included in gross income in the taxable year of inclusion as taxes related to passive income to the extent of the excess of the product of (A) the highest rate of tax in section 11 (determined with regard to section 15 and determined as of the year of inclusion) and (B) the amount of the inclusion (after allocation of parent expenses) over (C) the taxes paid or accrued, or deemed paid or accrued, in the year of inclusion. The taxpayer shall treat any taxes paid or accrued, or deemed paid or accrued, on the distribution in excess of this amount as taxes related to general category income. If these additional taxes are not creditable in the year of distribution the carryover rules of section 904(c) apply. For purposes of this paragraph, the foreign tax on a subpart F inclusion shall be considered increased on distribution of the earnings and profits associated with that inclusion if the total of taxes paid and deemed paid on the inclusion and the distribution (taking into account any reductions in tax and any withholding taxes) is greater than the total taxes deemed paid in the year of inclusion. Any foreign currency loss associated with the earnings and profits that are

distributed with respect to the inclusion is not to be considered as giving rise to an increase in tax.

(iv) *Increase in taxes paid by successors*—(A) *General rule.* Except as provided in paragraph (c)(6)(iv)(B) of this section, if passive earnings and profits previously included in income of a United States shareholder are distributed to a person that was not a United States shareholder of the distributing corporation in the year the earnings were included, any increase in foreign taxes paid or accrued, or deemed paid or accrued, on that distribution shall be treated as taxes related to general category income, regardless of whether the previously-taxed income was considered high-taxed income under section 904(d)(2)(F) in the year of inclusion.

(B) *Exception.* For a special rule applicable to distributions prior to August 6, 1997, to U.S. shareholders not entitled to look-through treatment, see 26 CFR 1.904-4(c)(6)(iv)(B) (revised as of April 1, 2006).

(C) *Effective date.* This paragraph (c)(6)(iv) applies to taxable years beginning after December 31, 1986. However, for taxable years beginning before January 1, 2001, taxpayers may rely on § 1.904-4(c)(6)(iv) of regulations project INTL-1-92, published at 1992-1 C.B. 1209. See § 601.601(d)(2) of this chapter.

(7) *Application of this paragraph to certain reductions of tax on distributions of income*—(i) *In general.* If the effective rate of tax imposed by a foreign country on income of a foreign corporation that is included in a taxpayer's gross income is reduced under foreign law on distribution of such income, the rules of this paragraph (c) apply at the time that the income is included in the taxpayer's gross income without regard to the possibility of subsequent reduction of foreign tax on the distribution. If the inclusion is considered to be high-taxed income, then the taxpayer shall treat the inclusion as general category income. When the foreign corporation distributes the earnings and profits to which the inclusion was attributable and the foreign tax on the inclusion is reduced, then the taxpayer shall redetermine whether the inclusion should be considered to be high-taxed income provided that a redetermination of

United States tax liability is required under section 905(c). If, taking into account the reduction in foreign tax, the inclusion would not have been considered high-taxed income, then the taxpayer, in redetermining its United States tax liability for the year or years affected, shall treat the inclusion and the associated taxes (as reduced on the distribution) as passive income and taxes. See section 905(c) and the regulations thereunder regarding the method of adjustment. For this purpose, the foreign tax on a subpart F inclusion shall be considered reduced on distribution of the earnings and profits associated with the inclusion if the total of taxes paid and deemed paid on the inclusion and the distribution (taking into account any reductions in tax and any withholding taxes) is less than the total taxes deemed paid in the year of inclusion. Any foreign currency gain associated with the earnings and profits that are distributed with respect to the inclusion is not to be considered a reduction of tax.

(ii) *Allocation of reductions of foreign tax.* For purposes of paragraph (c)(7)(i) of this section, reductions in foreign tax shall be allocated among the separate categories under the same principles as those of § 1.904-6 for allocating taxes among the separate categories. Thus, for purposes of determining to which year's taxes the reduction in taxes relates, foreign law shall apply. If, however, foreign law does not attribute a reduction in taxes to a particular year or years, then the reduction in taxes shall be attributable, on an annual last in-first out (LIFO) basis, to foreign taxes potentially subject to reduction that are associated with previously taxed income, then on a LIFO basis to foreign taxes associated with income that under paragraph (c)(7)(iii) of this section remains as passive income but that was excluded from subpart F income under section 954(b)(4), and finally on a LIFO basis to foreign taxes associated with other earnings and profits. Furthermore, in applying the ordering rules of section 959(c), distributions shall be considered made on a LIFO basis first out of earnings described in section 959(c) (1) and (2), then on a LIFO basis out of earnings and

profits associated with income that remains passive income under paragraph (c)(7)(iii) of this section but that was excluded from subpart F under section 954(b)(4), and finally on a LIFO basis out of other earnings and profits. For purposes of this paragraph (c)(7)(ii), foreign law is not considered to attribute a reduction in tax to a particular year or years if foreign law attributes the tax reduction to a pool or group containing income from more than one taxable year and such pool or group is defined based on a characteristic of the income (for example, the rate of tax paid with respect to the income) rather than on the taxable year in which the income is derived.

(iii) *Interaction with section 954(b)(4).* If the effective rate of tax imposed by a foreign country on income of a foreign corporation is reduced under foreign law on distribution of that income, the rules of section 954(b)(4) shall be applied without regard to the possibility of subsequent reduction of foreign tax. If a taxpayer excludes passive income from a controlled foreign corporation's foreign personal holding company income under these circumstances, then, notwithstanding the general rule of § 1.904-5(d)(2), the income shall be considered to be passive income until distribution of that income. At that time, the rules of this paragraph shall apply to determine whether the income is high-taxed income and, therefore, general category income. For purposes of determining whether a reduction in tax is attributable to taxes on income excluded under section 954(b)(4), the rules of paragraph (c)(7)(ii) of this section apply. The rules of paragraph (c)(7)(ii) of this section shall apply for purposes of ordering distributions to determine whether such distributions are out of earnings and profits associated with such excluded income. For an example illustrating the operation of this paragraph (c)(7)(iii), see paragraph (c)(8) *Example (7)* of this section.

(8) *Examples.* The following examples illustrate the application of this paragraph (c).

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S is a single qualified business unit (QBU) operating in foreign country

X. In 1988, S earns \$130 of gross passive royalty income from country X sources, and incurs \$30 of expenses that do not include any payments to P. S's \$100 of net passive royalty income is subject to \$30 of foreign tax, and is included under section 951 in P's gross income for the taxable year. P allocates \$50 of expenses to the \$100 (consisting of the \$70 section 951 inclusion and \$30 section 78 amount), resulting in a net inclusion of \$50. After application of the high-tax kick-out rules of paragraph (c)(1) of this section, the \$50 inclusion is treated as general category income, and the \$30 of taxes deemed paid are treated as taxes imposed on general category income, because the foreign taxes paid and deemed paid on the income exceed the highest United States tax rate multiplied by the \$50 inclusion ($\$30 > \$17 (.34 \times \$50)$).

Example 2. The facts are the same as in *Example (1)* except that instead of earning \$130 of gross passive royalty income, S earns \$65 of gross passive royalty income from country X sources and \$65 of gross passive interest income from country Y sources. S incurs \$15 of expenses and \$5 of foreign tax with regard to the royalty income and incurs \$15 of expenses and \$10 of foreign tax with regard to the interest income. P allocates \$50 of expenses pro rata to the \$50 inclusion (\$45 section 951 inclusion and \$5 section 78 amount) attributable to the royalty income earned by S and the \$50 inclusion (\$40 section 951 inclusion and \$10 section 78 amount) attributable to the interest income earned by S. Under paragraph (c)(4) of this section, the high-tax test is applied separately to the section 951 inclusion attributable to the income from X sources and the section 951 inclusion attributable to the income from Y sources. Therefore, after allocation of P's \$50 of expenses, the resulting \$25 inclusion attributable to the royalty income from X sources is still treated as passive income because the foreign taxes paid and deemed paid on the income do not exceed the highest United States tax rate multiplied by the \$25 inclusion ($\$5 < \$8.50 (.34 \times \$25)$). The \$25 inclusion attributable to the interest income from Y sources is treated as general category income because the foreign taxes paid and deemed paid exceed the highest United States tax rate multiplied by the \$25 inclusion ($\$10 > \$8.50 (.34 \times \$25)$).

Example 3. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S is incorporated and operating in country Y and has a branch in country Z. S has two QBUs (QBU Y and QBU Z). In 1988, S earns \$65 of gross passive royalty income in country Y through QBU Y and \$65 of gross passive royalty income in country Z through QBU Z. S allocates \$15 of expenses to the gross passive royalty income earned by each QBU, resulting in net income of \$50 in each QBU. Country Y imposes \$5 of foreign tax on the royalty income earned in Y, and country

Z imposes \$10 of tax on royalty income earned in Z. All of S's income constitutes subpart F foreign personal holding company income that is passive income and is included in P's gross income for the taxable year. P allocates \$50 of expenses pro rata to the \$100 subpart F inclusion attributable to the QBUs (consisting of the \$45 section 951 inclusion derived through QBU Y, the \$5 section 78 amount attributable to QBU Y, the \$40 section 951 inclusion derived through QBU Z, and the \$10 section 78 amount attributable to QBU Z), resulting in a net inclusion of \$50. Pursuant to paragraph (c)(4) of this section, the high-tax kickout rules must be applied separately to the subpart F inclusion attributable to the income earned by QBU Y and the income earned by QBU Z. After application of the high-tax kickout rules, the \$25 inclusion attributable to Y will still be treated as passive income because the foreign taxes paid and deemed paid on the income do not exceed the highest United States tax rate multiplied by the \$25 inclusion ($\$5 < \$8.50 (.34 \times \$25)$). The \$25 inclusion attributable to Z will be treated as general category income because the foreign taxes paid and deemed paid on the income exceed the highest United States tax rate multiplied by the \$25 inclusion ($\$10 \leq \$8.50 (.34 \times \$25)$).

Example 4. Domestic corporation M operates in branch form in foreign countries X and Y. The branches are qualified business units (QBUs), within the meaning of section 989(a). In 1988, QBU X earns passive royalty income, interest income and rental income. All of the QBU X passive income is from Country Z sources. The royalty income is not subject to a withholding tax, and is not taxed by Country X, and the interest and the rental income are subject to a 4 percent and 10 percent withholding tax, respectively. QBU Y earns interest income in Country Y that is not subject to foreign tax. For purposes of determining whether M's foreign source passive income is high-taxed income, the rental income and the interest income earned in QBU X are treated as one item of income pursuant to paragraphs (c) (4)(ii) and (3)(ii) of this section. The interest income earned in QBU Y and the royalty income earned in QBU X are each treated as a separate item of income under paragraphs (c)(4)(i) (with respect to QBU Y's interest income) and (c) (4)(ii) and (3)(iii) (with respect to QBU X's royalty income) of this section.

Example 5. S, a controlled foreign corporation incorporated in foreign country R, is a wholly-owned subsidiary of P, a domestic corporation. For 1988, P is required under section 951(a) to include in gross income \$80 (not including the section 78 amount) attributable to the earnings and profits of S for such year, all of which is foreign personal holding company income that is passive rent or royalty income. S does not make any distributions in 1988 or 1989. Foreign income

taxes paid by S for 1988 that are deemed paid by P for such year under section 960(a) with respect to the section 951(a) inclusion equal \$20. Twenty dollars (\$20) of P's expenses are properly allocated to the section 951(a) inclusion. The foreign income tax paid with respect to the section 951(a) inclusion does not exceed the highest United States tax rate multiplied by the amount of income after allocation of parent expenses ($\$20 < \$27.20 (.34 \times \$80)$). Thus, P's section 951(a) inclusion for 1988 is included in P's passive income and the \$20 of taxes attributable to that inclusion are treated as taxes related to passive income. In 1990, S distributes \$80 to P, and under section 959 that distribution is treated as attributable to the earnings and profits with respect to the amount included in income by P in 1988 and is excluded from P's gross income. Foreign country R imposes a withholding tax of \$15 on the distribution in 1990. Under paragraph (c)(6)(i) of this section, the withholding tax in 1990 does not affect the characterization of the 1988 inclusion as passive income nor does it affect the characterization of the \$20 of taxes paid in 1988 as taxes paid with respect to passive income. No further parent expenses are allocable to the receipt of that distribution. In 1990, the foreign taxes paid (\$15) exceed the product of the highest United States tax rate and the amount of the inclusion reduced by taxes deemed paid in the year of inclusion ($\$15 > ((.34 \times \$80) - \$20)$). Thus, under paragraph (c)(6)(iii) of this section, \$7.20 ($((.34 \times \$80) - \$20)$) of the \$15 withholding tax paid in 1990 is treated as taxes related to passive income and the remaining \$7.80 ($\$15 - \7.20) of the withholding tax is treated as related to general category income.

Example 6. S, a controlled foreign corporation, is a wholly-owned subsidiary of P, a domestic corporation. P and S are calendar year taxpayers. In 1987, S's only earnings consist of \$200 of passive income that is foreign personal holding company income that is earned in a foreign country X. Under country X's tax system, the corporate tax on particular earnings is reduced on distribution of those earnings and no withholding tax is imposed. In 1987, S pays \$100 of foreign tax. P does not elect to exclude this income from subpart F under section 954(b)(4) and includes \$200 in gross income (\$100 of net foreign personal holding company income and \$100 of the section 78 amount). At the time of the inclusion, the income is considered to be high-taxed income under paragraphs (c)(1) and (c)(6)(i) of this section and is general category income to P. S does not distribute any of its earnings in 1987. In 1988, S has no earnings. On December 31, 1988, S distributes the \$100 of earnings from 1987. At that time, S receives a \$50 refund from X attributable to the reduction of the country X corporate

tax imposed on those earnings. Under paragraph (c)(7)(i) of this section, P must redetermine whether the 1987 inclusion should be considered to be high-taxed income. By taking into account the reduction in foreign tax, the inclusion would not have been considered high-taxed income. Therefore, P must redetermine its foreign tax credit for 1987 and treat the inclusion and the taxes associated with the inclusion as passive income and taxes. P must follow the appropriate section 905(c) procedures.

Example 7. The facts are the same as in *Example 6* except that P elects to apply section 954(b)(4) to S's passive income that is subpart F income. Although the income is not considered to be subpart F income, it remains passive income until distribution. In 1988, S distributes \$150 to P. The distribution is a dividend to P because S has \$150 of accumulated earnings and profits (the \$100 of earnings in 1987 and the \$50 refund in 1988). P has no expenses allocable to the dividend from S. In 1988, the income is subject to the high-tax kick-out rules under paragraph (c)(7)(iii) of this section. The income is passive income to P because the foreign taxes paid and deemed paid by P with respect to the income do not exceed the highest United States tax rate on that income.

Example 8. The facts are the same as in *Example 6* except that the distribution in 1988 is subject to a withholding tax of \$25. Under paragraph (c)(7)(i) of this section, P must redetermine whether the 1987 inclusion should be considered to be high-taxed income because there is a net \$25 reduction of foreign tax. By taking into account both the reduction in foreign corporate tax and the withholding tax, the inclusion would continue to be considered high-taxed income. P must follow the appropriate section 905(c) procedures. P must redetermine its foreign tax credit for 1987, but the inclusion and the \$75 taxes (\$50 of deemed paid tax and \$25 withholding tax) will continue to be treated as general category income and taxes.

Example 9. (i) S, a controlled foreign corporation operating in country G, is a wholly-owned subsidiary of P, a domestic corporation. P and S are calendar year taxpayers. Country G imposes a tax of 50 percent on S's earnings. Under country G's system, the foreign corporate tax on particular earnings is reduced on distribution of those earnings to 30 percent and no withholding tax is imposed. Under country G's law, distributions are treated as made out of a pool of undistributed earnings subject to the 50 percent tax rate. For 1987, S's only earnings consist of passive income that is foreign personal holding company income that is earned in foreign country G. S has taxable income of \$110 for United States purposes and \$100 for country G purposes. Country G, therefore, imposes a tax of \$50 on the 1987 earnings of S. P does not elect to exclude this income

from subpart F under section 954(b)(4) and includes \$110 in gross income (\$60 of net foreign personal holding company income and \$50 of the section 78 amount). At the time of the inclusion, the income is considered to be high-taxed income under paragraph (c) of this section and is general category income to P. S does not distribute any of its taxable income in 1987.

(ii) In 1988, S earns general category income that is not subpart F income. S again has \$110 in taxable income for United States purposes and \$100 in taxable income for country G purposes, and S pays \$50 of tax to foreign country G. In 1989, S has no taxable income or earnings. On December 31, 1989, S distributes \$60 of earnings and receives a refund of foreign tax of \$24. Country G treats the distribution of earnings as out of the 50% tax rate pool of earnings accumulated in 1987 and 1988. However, under paragraph (c)(7)(ii) of this section, the distribution, and, therefore, the reduction of tax is treated as first attributable to the \$60 of passive earnings attributable to income previously taxed in 1987. However, because, under foreign law, only 40 percent (the reduction in tax rates from 50 percent to 30 percent is a 40 percent reduction in the tax) of the \$50 of foreign taxes on the passive earnings can be refunded, \$20 of the \$24 foreign tax refund reduces foreign taxes on passive earnings. The other \$4 of the tax refund reduces the general category taxes from \$50 to \$46 (even though for United States purposes the \$60 distribution is entirely out of passive earnings).

(iii) Under paragraph (c)(7) of this section, P must redetermine whether the 1987 inclusion should be considered to be high-taxed income. By taking into account the reduction in foreign tax, the inclusion would not have been considered high-taxed income (\$30 < .34 × \$110). Therefore, P must redetermine its foreign tax credit for 1987 and treat the inclusion and the taxes associated with the inclusion as passive income and taxes. P must follow the appropriate section 905(c) procedures.

Example 10. P, a domestic corporation, earns \$100 of passive royalty income from sources within the United States. Under the laws of Country X, however, that royalty is considered to be from sources within Country X and Country X imposes a 10 percent withholding tax on the payment of the royalty. P also earns \$100 of passive foreign source dividend income subject to a 10 percent withholding tax to which \$15 of expenses are allocated. In determining whether P's passive income is high-taxed, the \$10 withholding tax on P's royalty income is allocated to passive income, and within the passive category to the group of income described in paragraph (c)(3)(ii) of this section (passive income subject to a withholding tax of less than 15 percent (but greater than zero)). For purposes of determining whether

the income is high-taxed, however, only the foreign source dividend income is taken into account. The foreign source dividend income will still be treated as passive income because the foreign taxes paid on the passive income in the group (\$20) do not exceed the highest United States tax rate multiplied by the \$85 of net foreign source income in the group (\$20 is less than $\$28.90 (\$100 - \$15) \times .34$).

Example 11. In 2001, *P*, a U.S. citizen with a tax home in Country *X*, earns the following items of gross income: \$400 of foreign source, passive limitation interest income not subject to foreign withholding tax but subject to Country *X* income tax of \$100, \$200 of foreign source, passive limitation royalty income subject to a 5 percent foreign withholding tax (foreign tax paid is \$10), \$1,300 of foreign source, passive limitation rental income subject to a 25 percent foreign withholding tax (foreign tax paid is \$325), \$500 of foreign source, general category income that gives rise to a \$250 foreign tax, and \$2,000 of U.S. source capital gain that is not subject to any foreign tax. *P* has a \$900 deduction allocable to its passive rental income. *P*'s only other deduction is a \$700 capital loss on the sale of stock that is allocated to foreign source passive limitation income under § 1.865-2(a)(3)(i). The \$700 capital loss is initially allocated to the group of passive income subject to no withholding tax but subject to foreign tax other than withholding tax. The \$300 amount by which the capital loss exceeds the income in the group must be reapportioned to the other groups under paragraph (c)(2)(ii)(B) of this section. The royalty income is thus reduced by \$100 to \$100 ($\$200 - (\$300 \times (200/600))$) and the rental income is thus reduced by \$200 to \$200 ($\$400 - (\$300 \times (400/600))$). The \$100 royalty income is not high-taxed and remains passive income because the foreign taxes do not exceed the highest United States rate of tax on that income. Under the high-tax kick-out, the \$200 of rental income and the \$325 of associated foreign tax are assigned to the general category category.

Example 12. The facts are the same as in *Example 11* except the amount of the capital loss that is allocated under § 1.865-2(a)(3)(i) and paragraph (c)(2) of this section to the group of foreign source passive income subject to no withholding tax but subject to foreign tax other than withholding tax is \$1,200. Under paragraph (c)(2)(ii)(B) of this section, the excess deductions of \$800 must be reapportioned to the \$200 of net royalty income subject to a 5 percent withholding tax and the \$400 of net rental income subject to a 15 percent or greater withholding tax. The income in each of these groups is reduced to zero, and the foreign taxes imposed on the rental and royalty income are considered related to general category income. The remaining loss of \$200 constitutes a separate limitation loss with respect to passive income.

Example 13. In 2001, *P*, a domestic corporation, earns a \$100 dividend that is foreign source passive limitation income subject to a 30-percent withholding tax. A foreign tax credit for the withholding tax on the dividend is disallowed under section 901(k). A deduction for the tax is allowed, however, under sections 164 and 901(k)(7). In determining whether *P*'s passive income is high-taxed, the \$100 dividend and the \$30 deduction are allocated to the first group of income described in paragraph (c)(3)(iv) of this section (passive income subject to no withholding tax or other foreign tax).

(d) [Reserved]

(e) *Financial services income*—(1) *In general.* The term “financial services income” means income derived by a financial services entity, as defined in paragraph (e)(3) of this section, that is:

(i) Income derived in the active conduct of a banking, insurance, financing, or similar business (active financing income as defined in paragraph (e)(2) of this section), except income described in paragraph (e)(2)(i)(W) of this section (high withholding tax interest);

(ii) Passive income as defined in section 904(d) (2) (A) and paragraph (b) of this section as determined before the application of the exception for high-taxed income;

(iii) Export financing interest as defined in section 904(d)(2)(G) and paragraph (h) of this section that, but for section 904(d)(2)(B)(ii), would also meet the definition of high withholding tax interest; or

(iv) Incidental income as defined in paragraph (e)(4) of this section.

(2) *Active financing income*—(i) *Income included.* For purposes of paragraph (e)(1) and (e)(3) of this section, income is active financing income only if it is described in any of the following subdivisions.

(A) Income that is of a kind that would be insurance income as defined in section 953(a) (including related party insurance income as defined in section 953(c)(2)) and determined without regard to those provisions of section 953(a)(1)(A) that limit insurance income to income from countries other than the country in which the corporation was created or organized.

(B) Income from the investment by an insurance company of its unearned

premiums or reserves ordinary and necessary to the proper conduct of the insurance business, income from providing services as an insurance underwriter, income from insurance brokerage or agency services, and income from loss adjuster and surveyor services.

(C) Income from investing funds in circumstances in which the taxpayer holds itself out as providing a financial service by the acceptance or the investment of such funds, including income from investing deposits of money and income earned investing funds received for the purchase of traveler's checks or face amount certificates.

(D) Income from making personal, mortgage, industrial, or other loans.

(E) Income from purchasing, selling, discounting, or negotiating on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness.

(F) Income from issuing letters of credit and negotiating drafts drawn thereunder.

(G) Income from providing trust services.

(H) Income from arranging foreign exchange transactions, or engaging in foreign exchange transactions.

(I) Income from purchasing stock, debt obligations, or other securities from an issuer or holder with a view to the public distribution thereof or offering or selling stock, debt obligations, or other securities for an issuer or holder in connection with the public distribution thereof, or participating in any such undertaking.

(J) Income earned by broker-dealers in the ordinary course of business (such as commissions) from the purchase or sale of stock, debt obligations, commodities futures, or other securities or financial instruments and dividend and interest income earned by broker-dealers on stock, debt obligations, or other financial instruments that are held for sale.

(K) Service fee income from investment and correspondent banking.

(L) Income from interest rate and currency swaps.

(M) Income from providing fiduciary services.

(N) Income from services with respect to the management of funds.

(O) Bank-to-bank participation income.

(P) Income from providing charge and credit card services or for factoring receivables obtained in the course of providing such services.

(Q) Income from financing purchases from third parties.

(R) Income from gains on the disposition of tangible or intangible personal property or real property that was used in the active financing business (as defined in paragraph (e)(3)(i) of this section) but only to the extent that the property was held to generate or generated active financing income prior to its disposition.

(S) Income from hedging gain with respect to other active financing income.

(T) Income from providing traveller's check services.

(U) Income from servicing mortgages.

(V) Income from a finance lease. For this purpose, a finance lease is any lease that is a direct financing lease or a leveraged lease for accounting purposes and is also a lease for tax purposes.

(W) High withholding tax interest that would otherwise be described as active financing income.

(X) Income from providing investment advisory services, custodial services, agency paying services, collection agency services, and stock transfer agency services.

(Y) Any similar item of income that is disclosed in the manner provided in the instructions to the Form 1118 or 1116 or that is designated as a similar item of income in guidance published by the Internal Revenue Service.

(3) *Financial services entities*—(i) *In general.* The term “financial services entity” means an individual or entity that is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business (active financing business) for any taxable Year. Except as provided in paragraph (e)(3)(ii) of this section, a determination of whether an entity is a financial services entity shall be done on an entity-by-entity basis. An individual or entity is predominantly engaged in the active financing business for any year if for that year at least 80 percent of its

gross income is income described in paragraph (e)(2)(i) of this section. For this purpose, gross income includes all income realized by an individual or entity, whether includible or excludible from gross income under other operative provisions of the Code, but excludes gain from the disposition of stock of a corporation that prior to the disposition of its stock is related to the transferor within the meaning of section 267(b). For this purpose, income received from a related person that is a financial services entity shall be excluded if such income is characterized under the look-through rules of section 904(d)(3) and § 1.904-5. In addition, income received from a related person that is not a financial services entity but that is characterized as financial services income under the look-through rules shall be excluded. *See* paragraph (e)(3)(iv) *Example 5* of this section. Any income received from a related person that is characterized under the look-through rules and that is not otherwise excluded by this paragraph will retain its character either as active financing income or other income in the hands of the recipient for purposes of determining if the recipient is a financial services entity and if the income is financial services income to the recipient. For purposes of this paragraph, related person is defined in § 1.904-5(i)(1).

(ii) *Special rule for affiliated groups.* In the case of any corporation that is not a financial services entity under paragraph (e)(3)(i) of this section, but is a member of an affiliated group, such corporation will be deemed to be a financial services entity if the affiliated group as a whole meets the requirements of paragraph (e)(3)(i) of this section. For purposes of this paragraph (e)(3)(ii), affiliated group means an affiliated group as defined in section 1504(a), determined without regard to section 1504(b)(3). In counting the income of the group for purposes of determining whether the group meets the requirements of paragraph (e)(3)(i) of this section, the following rules apply. Only the income of group members that are United States corporations or foreign corporations that are controlled foreign corporations in which United States members of the affi-

ated group own, directly or indirectly, at least 80 percent of the total voting power and value of the stock shall be included. For purposes of this paragraph (e)(3)(ii), indirect ownership shall be determined under section 318 and the regulations under that section. The income of the group will not include any income from transactions with other members of the group. Passive income will not be considered to be active financing income merely because that income is earned by a member of the group that is a financial services entity without regard to the rule of this paragraph (e)(3)(ii). This paragraph (e)(3)(ii) applies to taxable years beginning after December 31, 2000.

(iii) *Treatment of partnerships and other pass-through entities.* For purposes of determining whether a partner (including a partnership that is a partner in a second partnership) is a financial services entity, all of the partner's income shall be taken into account, except that income that is excluded under paragraph (e)(3)(i) of this section shall not be taken into account. Thus, if a partnership is determined to be a financial services entity none of the income of the partner received from the partnership that is characterized under the look-through rules shall be included for purpose of determining if the partner is a financial services entity. If a partnership is determined not to be a financial services entity, then income of the partner from the partnership that is characterized under the look-through rules will be taken into account (unless such income is financial services income) and such income will retain its character either as active financing income or as other income in the hands of the partner for purposes of determining if the partner is a financial service entity and if the income is financial services income to the partner. If a partnership is a financial services entity and the partner's income from the partnership is characterized as financial services income under the look-through rules, then, for purposes of determining a partner's foreign tax credit limitation, the income from the partnership shall be considered to be financial services income to the partner regardless of

whether the partner is itself a financial services entity. The rules of this paragraph (e)(3)(iii) will apply for purposes of determining whether an owner of an interest in any other pass-through entity the character of the income of which is preserved when such income is included in the income of the owner of the interest is a financial services entity.

(iv) *Examples.* The principles of paragraph (e)(3) of this section are illustrated by the following examples.

Example 1. P is a domestic corporation that owns 100 percent of the stock of S, a controlled foreign corporation incorporated in Country X. For the 1990 taxable year, 60 percent of S's income is active financing income that consists of income that will be considered general limitation or passive income if S is not a financial services entity. The other 40 percent of S's income is passive non-active financing income. S is not a financial services entity and its active financing income thus retains its character as general limitation and passive income. S makes an interest payment to P in 1990 that is characterized under the look-through rules. Although the interest is not financial services income to S under the look-through rules, it retains its character as active financing income when paid to P and P must take that income into account in determining whether it is a financial services entity under paragraph (e)(3)(i) of this section. If P is determined to be a financial services entity, both the portion of the interest payment characterized as active financing income (whether general limitation or passive income in S's hands) and the portion characterized as passive non-active financing income received from S will be recharacterized as financial services income.

Example 2. Foreign corporation A, which is not a controlled foreign corporation, owns 100 percent of the stock of domestic corporation B, which owns 100 percent of the stock of domestic corporation C. A also owns 100 percent of the stock of foreign corporation D. D owns 100 percent of the stock of domestic corporation E, which owns 100 percent of the stock of controlled foreign corporation F. All of the corporations are members of an affiliated group within the meaning of section 1504(a) (determined without regard to section 1504(b)(3)). Pursuant to paragraph (e)(3)(ii) of this section, however, only the income of B, C, E, and F is counted in determining whether the group meets the requirements of paragraph (e)(3)(i) of this section. For the 2001 taxable year, B's income consists of \$95 of active financing income and \$5 of passive non-active financing income. C has \$40 of active financing income and \$20 of

passive non-active financing income. E has \$70 of active financing income and \$15 of passive non-active financing income. F has \$10 of passive income. B and E qualify as financial services entities under the entity test of paragraph (e)(3)(i) of this section. Therefore, B and E are financial services entities without regard to whether the group as a whole is a financial services entity and all of the income of B and E shall be treated as financial services income. C and F do not qualify as financial services entities under the entity test of paragraph (e)(3)(i) of this section. However, under the affiliated group test of paragraph (e)(3)(ii) of this section, C and F are financial services entities because at least 80 percent of the group's total income consists of active financing income (\$205 of active financing income is 80.4 percent of \$255 total income). B's and E's passive income is not treated as active financing income for purposes of the affiliated group test of paragraph (e)(3)(ii) of this section even though it is treated as financial services income without regard to whether the group satisfies the affiliated group test. Once C and F are determined to be financial services entities under the affiliated group test, however, all of the passive income of the group is treated as financial services income. Thus, 100 percent of the income of B, C, E, and F for 2001 is financial services income.

Example 3. PS is a domestic partnership operating in branch form in foreign country X. PS has two equal general partners, A and B. A and B are domestic corporations that each operate in branch form in foreign countries Y and Z. All of A's income, except that derived through PS, is manufacturing income. All of B's income, except that derived through PS, is active financing income. A and B's only income from PS are distributive shares of PS's income. PS is a financial services entity and all of its income is financial services income. The income from PS is excluded in determining if A or B are financial services entities. Thus, A is not a financial services entity because none of A's income is active financing income and B is a financial services entity because all of B's income is active financing income. However, both A and B's distributive shares of PS's taxable income consist of financial services income even though A is not a financial services entity.

Example 4. PS is a domestic partnership operating in foreign country X. A and B are domestic corporations that are equal general partners in PS and, therefore, the look-through rules apply for purposes of characterizing A's and B's distributive shares of PS's income. Fifty (50) percent of PS's gross income is active financing income that is not high withholding tax interest. The active financing income includes income that also meets the definition of passive income and income that meets the definition of general

limitation income. The other 50 percent of PS's income is from manufacturing. PS is, therefore, not a financial services entity. A's and B's distributive shares of partnership taxable income consist of general limitation manufacturing income and active financing income. Under paragraph (c)(3)(i) of this section, the active financing income shall be financial services income to A or B if either A or B is determined to be a financial services entity. If A or B is not a financial services entity, the distributive shares of income from PS will not be financial services income to A or B and will consist of passive and general limitation income. All of the income from PS is included in determining if A or B are financial services entities.

Example 5. P is a United States corporation that is not a financial services entity. P owns 100 percent of the stock of S, a controlled foreign corporation that is not a financial services entity. S owns 100 percent of the stock of T, a controlled foreign corporation that is a financial services entity. In 1991, T pays a dividend to S. The dividend from T is characterized under the look-through rules of section 904(d)(3). Pursuant to paragraph (e)(3)(i) of this section, the dividend from T is excluded in determining whether S is a financial services entity. S is determined not to be a financial services entity but the dividend retains its character as financial services income in S's hands. Any subpart F inclusion or dividend to P out of earnings and profits attributable to the dividend from T will be excluded in determining whether P is a financial services entity but the inclusion or dividend will retain its character as financial services income.

(4) *Definition of incidental income*—(i) *In general*—(A) *Rule.* Incidental income is income that is integrally related to active financing income of a financial services entity. Such income includes, for example, income from precious metals trading and commodity trading that is integrally related to futures income. If securities, shares of stock, or other types of property are acquired by a financial services entity as an ordinary and necessary incident to the conduct of an active financing business, the income from such property will be considered to be financial services income but only so long as the retention of such property remains an ordinary or necessary incident to the conduct of such business. Thus property, including stock, acquired as the result of, or in order to prevent, a loss in an active financing business upon a loan held by the taxpayer in the ordinary course of such business will be considered ordi-

nary and necessary to the conduct of such business, but income from such property will be considered financial services income only so long as the holding of such property remains an ordinary and necessary incident to the conduct of such business. If an entity holds such property for five years or less then the property is considered held incident to the financial services business. If an entity holds such property for more than five years, a presumption will be established that the entity is not holding such property incident to its financial services business. An entity will be able to rebut the presumption by demonstrating that under the facts and circumstances it is not holding the property as an investment. However, the fact that an entity holds the property for more than five years and is not able to rebut the presumption that it is not holding the property incident to its financial services business will not affect the characterization of any income received from the property during the first five years as financial services income.

(B) *Examples.* The following examples illustrate the application of paragraph (e)(4)(i) of this section.

Example 1. X is a financial services entity within the meaning of paragraph (e)(3)(i) of this section. In 1987, X made a loan in the ordinary course of its business to an unrelated foreign corporation, Y. As security for that loan, Y pledged certain operating assets. Those assets generate income of a type that would be subject to the general limitation. In January 1989, Y defaulted on the loan and forfeited the collateral. During the period X held the assets, X earned operating income generated by those assets. This income was applied in partial satisfaction of Y's obligation. In 1993, X sold the forfeited assets. The sales proceeds were in excess of the remainder of Y's obligation. The operating income received in the period from 1989 to 1993 and the income on the sale of the assets in 1993 are financial services income of X.

Example 2. The facts are the same as in *Example 1*, except that instead of pledging its operating assets as collateral for the loan, Y pledged the stock of its operating subsidiary Z. In 1993 X sold the stock of Z in complete satisfaction of Y's obligation. X's income from the sale of Z stock in satisfaction of Y's obligation is financial services income.

Example 3. P, a domestic corporation, is a financial services entity within the meaning of paragraph (e)(3)(i) of this section. P holds

a United States dollar denominated debt (the “obligation”) of the Central Bank of foreign country X. The obligation evidences a loan of \$100 made by P to the Central Bank. In 1988, pursuant to a program of country X, P delivers the obligation to the Central Bank which credits 70 units of country X currency to M, a country X corporation. M issues all of its only class of capital stock to P. M invests the 70 units of country X currency in the construction and operation of a new hotel in X. In 1994, M distributes 10 units of country X currency to P as a dividend. P is not able to rebut the presumption that it is not holding the stock of M incident to its financial services business. The dividend to P is, therefore, not financial services income.

(ii) *Income that is not incidental income.* Income that is attributable to non-financial activity is not incidental income within the meaning of paragraph (e)(4) (i) and (ii) of this section solely because such income represents a relatively small proportion of the taxpayer’s total income or that the taxpayer engages in non-financial activity on a sporadic basis. Thus, for example, income from data processing services provided to related or unrelated parties or income from the sale of goods or non-financial services (for example travel services) is not financial services income, even if the recipient is a financial services entity.

(5) *Exceptions.* Financial services income does not include income that is:

(i) Export financing interest as defined in section 904(d)(2)(G) and paragraph (h) of this section unless that income would be high withholding tax interest as defined in section 904(d)(2)(B) but for paragraph (d)(2)(B)(ii) of that section;

(ii) High withholding tax interest as defined in section 904(d)(2)(B) unless that income also meets the definition of export financing interest; and

(iii) Dividends from noncontrolled section 902 corporations as defined in section 904(d)(2)(E) paid in taxable years beginning before January 1, 2003.

(f)–(g) [Reserved]

(h) *Export financing interest*—(1) *Definitions*—(i) *Export financing interest.* The term “export financing interest” means any interest derived from financing the sale (or other disposition) for use or consumption outside the United States of any property that is manufactured, produced, grown, or extracted in the United States by the

taxpayer or a related person, and not more than 50 percent of the fair market value of which is attributable to products imported into the United States. For purposes of this paragraph, the term “United States” includes the fifty States, the District of Columbia, and the Commonwealth of Puerto Rico.

(ii) *Fair market value.* For purposes of this paragraph, the fair market value of any property imported into the United States shall be its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation. For purposes of determining the foreign content of an item of property imported into the United States, see section 927 and the regulations thereunder.

(iii) *Related person.* For purposes of this paragraph, the term “related person” has the meaning given it by section 954(d)(3) except that such section shall be applied by substituting “the person with respect to whom the determination is being made” for “controlled foreign corporation” each place it applies.

(2) *Treatment of export financing interest.* Except as provided in paragraph (h)(3) of this section, if a taxpayer (including a financial services entity) receives or accrues export financing interest from an unrelated person, then that interest shall be treated as general category income.

(3) *Exception.* Unless it is received or accrued by a financial services entity, export financing interest shall be treated as passive category income if that income is also related person factoring income. For this purpose, related person factoring income is—

(i) Income received or accrued by a controlled foreign corporation that is income described in section 864(d)(6) (income of a controlled foreign corporation from a loan for the purpose of financing the purchase of inventory property of a related person); or

(ii) Income received or accrued by any person that is income described in section 864(d)(1) (income from a trade receivable acquired from a related person).

(4) *Examples.* The following examples illustrate the operation of paragraph (h)(3) of this section:

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. S is not a financial services entity and has accumulated cash reserves. P has uncollected trade and service receivables of foreign obligors. P sells the receivables at a discount (“factors”) to S. The income derived by S on the receivables is related person factoring income. The income is also export financing interest. Because the income is related person factoring income, the income is passive income to S.

Example 2. Domestic corporation S is a wholly-owned subsidiary of domestic corporation P. S is not a financial services entity and has accumulated cash reserves. P has uncollected trade and service receivables of foreign obligors. P factors the receivables to S. The income derived by S on the receivables is related person factoring income. The income is also export financing interest. The income will be passive income to S.

Example 3. The facts are the same as in *Example 2* except that instead of factoring P’s receivables, S finances the sales of P’s goods by making loans to the purchasers of P’s goods. The interest derived by S on these loans is export financing interest and is not related person factoring income. The income will be general category income to S.

(5) *Income eligible for section 864(d)(7) exception (same country exception) from related person factoring treatment—(i) Income other than interest.* If any foreign person receives or accrues income that is described in section 864(d)(7) (income on a trade or service receivable acquired from a related person in the same foreign country as the recipient) and such income would also meet the definition of export financing interest if section 864(d)(1) applied to such income (income on a trade or service receivable acquired from a related person treated as interest), then the income shall be considered to be export financing interest and shall be treated as general category income.

(ii) *Interest income.* If export financing interest is received or accrued by any foreign person and that income would otherwise be treated as related person factoring income under section 864(d)(6) if section 864(d)(7) did not apply, section 904(d)(2)(B)(iii)(I) shall apply, and the interest shall be treated as general category income unless the interest is received or accrued by a financial services entity. If that interest is received or accrued by a financial services entity, section 904(d)(2)(C)(iii)(III) shall apply and the

interest shall be treated as general category income.

(iii) *Examples.* The following examples illustrate the operation of this paragraph (h)(5):

Example 1. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation P. Controlled foreign corporation T is a wholly-owned subsidiary of controlled foreign corporation S. S and T are incorporated in Country M. In 1987, P sells tractors to T, which T sells to X, an unrelated foreign corporation organized in country M. The tractors are to be used in country M. T uses a substantial part of its assets in its trade or business located in Country M. T has uncollected trade receivables from X that it factors to S. S derived more than 20 percent of its gross income for 1987 other than from an active financing business and the income derived by S from the receivables is not derived in an active financing business. Thus, pursuant to paragraph (e)(3)(i) of this section, S is not a financial services entity. The income is not related person factoring income because it is described in section 864(d)(7) (income eligible for the same country exception). If section 864(d)(1) applied, the income S derived from the receivables would meet the definition of export financing interest. The income, therefore, is considered to be export financing interest and is general category income to S.

Example 2. Controlled foreign corporation S is a wholly-owned subsidiary of domestic corporation, P. Controlled foreign corporation T is a wholly-owned subsidiary of controlled foreign corporation S. S and T are incorporated in country M. S is not a financial services entity. In 1987, P sells tractors to T, which T sells to X, a foreign partnership that is organized in country M and is related to S and T. S makes a loan to X to finance the tractor sales. The interest earned by S from financing the sales is described in section 864(d)(7) and is export financing interest. Therefore, the income shall be general category income to S.

(i) *Interaction of section 907(c) and income described in this section.* If a person receives or accrues income that is income described in section 907(c) (relating to oil and gas income), the rules of section 907(c) and the regulations thereunder, as well as the rules of this section, shall apply to the income. The reduction in amount allowed as foreign tax provided by section 907(a) shall therefore be calculated separately for income in each separate category.

(j) *Special rule for DASTM gain or loss.* Any DASTM gain or loss computed under § 1.985-3(d) must be allocated

among the categories of income under the rules of § 1.985-3 (e)(2)(iv) or (e)(3). The rules of § 1.985-3(e) apply before the rules of section 904(d)(2)(B)(iii)(II) (the exception from passive income for high-taxed income).

(k) *Special rule for alternative minimum tax foreign tax credit.* For purposes of computing the alternative minimum tax foreign tax credit under section 59(a), items included in alternative minimum taxable income by reason of section 56(g) (adjustments based on adjusted current earnings) shall be characterized as income described in a separate category under section 904(d) and this section based on the character of the underlying items of income.

(l) *Priority rule.* Income that meets the definitions of a separate category described in paragraph (m) of this section and another category of income described in section 904(d)(2)(A)(i) and (ii) will be subject to the separate limitation described in paragraph (m) of this section and will not be treated as general category income described in section 904(d)(2)(A)(ii).

(m) *Income treated as allocable to an additional separate category.* If section 904(a), (b), and (c) are applied separately to any category of income under the Internal Revenue Code (for example, under section 56(g)(4)(C)(iii)(IV), 245(a)(10), 865(h), 901(j), or 904(h)(10)), that category of income will be treated for all purposes of the Internal Revenue Code and regulations as if it were a separate category listed in section 904(d)(1).

(n) *Effective/applicability dates.* Paragraphs (a), (b), (h)(3), and (l) of this section shall apply to taxable years of United States persons and, for purposes of section 906, foreign persons beginning after December 31, 2006 and ending on or after December 21, 2007, and to taxable years of a foreign corporation which end with or within taxable years of its domestic corporate shareholder beginning after December 31, 2006 and ending on or after December 21, 2007. For purposes of determining whether passive income is high-taxed income, the grouping rules of paragraphs (c)(3) and (4) of this section apply in taxable years ending on or after April 20, 2009. See 26 CFR § 1.904-4T(c)(3) and (4) (revised as of April 1, 2009) for grouping

rules applicable to taxable years beginning after December 31, 2002, and ending before April 20, 2009. For corresponding rules applicable to taxable years beginning before January 1, 2003, see 26 CFR § 1.904-4(c)(2)(i) (revised as of April 1, 2006).

[T.D. 8214, 53 FR 27011, July 18, 1988]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.904-4, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at www.fdsys.gov.

§ 1.904-5 Look-through rules as applied to controlled foreign corporations and other entities.

(a) *Definitions.* For purposes of section 904(d)(3) and (4) and the regulations under section 904, the following definitions apply:

(1) The term *separate category* means, as the context requires, any category of income described in section 904(d)(1)(A) and (B) (or section 904(d)(1)(A), (B), (C), (D), (F), (G), (H), or (I) for taxable years beginning before January 1, 2007) and in § 1.904-4T(b) (or § 1.904-4(e) for taxable years beginning before January 1, 2007), any category of income described in § 1.904-4(m), or any category of earnings and profits to which income described in such provisions is attributable.

(2) The term *controlled foreign corporation* has the meaning given such term by section 957 (taking into account the special rule for certain captive insurance companies contained in section 953(c)).

(3) The term *United States shareholder* has the meaning given such term by section 951(b) (taking into account the special rule for certain captive insurance companies contained in section 953(c)), except that for purposes of this section, a United States shareholder shall include any member of the controlled group of the United States shareholder. For this purpose the controlled group is any member of the affiliated group within the meaning of section 1504(a)(1) except that “more than 50 percent” shall be substituted for “at least 80 percent” wherever it appears in section 1504(a)(2). For taxable years beginning before January 1, 2001, the preceding sentence shall be